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IN THE

Supreme Court of the United States

OCTOBER TERM, 1950.

No. .

THE MARSHALL DRUG COMPANY,

Petitioner,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable, the Chief Justice of the United States and Associate Justices of the Supreme Court of the United States:

Petitioner, by J. S. Seidman, its counsel, prays that a writ of certiorari issue to review the judgment of the United States Court of Claims, entered in the above entitled case on March 6, 1951.

Question Presented.

Did petitioner receive taxable income or a non-taxable gift on the cancellation by trade creditors of open account debt owing them by petitioner?

The Court of Claims held it was taxable income on the theory that where business debts and dealings are involved, there can be no gift.

Applicable Provisions of Internal Revenue Code (26 U. S. C. 1946 ed.).

Sec. 22. GROSS INCOME.

(a) General Definition.—"Gross income" includes gains, profits, and income * * * derived from any source whatever * * *.

(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this title: * * *

(3) Gifts, bequests, and devises.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income).

Statement.

Petitioner, an operator of a chain of retail drug stores, though having more assets than liabilities, was in a bad financial way in 1940 as a result of losses due to inept management. It then owed 947 trade creditors $521,860.

It asked its creditors for help in putting through a reorganization that would bring in new management. In response, over 80% of the claims were converted into preferred stock at par. Some creditors went further and put in fresh cash for preferred stock at par.

The creditors who did not convert their claims into stock were contacted by letter, in person, and by phone to invoke their sympathy and persuade them to make a contribution to petitioner's financial situation by

cancelling a part or all of their claims. Trade creditors with claims of $10,838.79 refused to budge and they were paid in full. However, trade creditors with face amount of claims of $72,848.80 agreed to take $46,696.11 and cancelled the remaining $26,152.69. It is with these cancellations that this case is concerned.

The cancellations varied from 10% to 100% (the latter applying to claims totalling $4,817.82). These percentages were based on the creditor's own arbitrary determination of the extent they were willing to help petitioner. To each such creditor petitioner sent an acknowledging letter of gratitude.

The creditors thought, with or without investigation, that full collection of their accounts could not be made and wrote off the cancelled amounts as a bad debt.

No controversy existed as to the amount of petitioner's debts. Petitioner never offered to buy the accounts from the creditors. No promise or obligation was made by petitioner to the creditors in return for the cancellation of their claims.

Reasons for Granting the Writ.

The reasons for granting this writ may be summarized as follows:

(1) There is here involved an important question of income tax law now bathed in a sea of doubt by reason of the uncertain metes and bounds growing out of three decisions of the Supreme Court.

(2) The lower courts are now in conflict.

(3) The decision of the Court of Claims is opposed to reason and justice.

(4) The principle at issue is of general concern to both government and taxpayer in the administration of the tax laws, and needs the determination of this court to eliminate further litigation.

Each of these will be discussed in sequential order.

(1) There is here involved an important question of income tax law now bathed in a sea of doubt by reason of the uncertain metes and bounds growing out of three decisions of the Supreme Court.

Three Supreme Court decisions were rendered on the subject of debt cancellation. Chronologically, the first was *U. S.* v. *Kirby Lumber Co.,* 284 U. S. 1, which held that the purchase by the debtor, in the open market, at a discount, of an undefaulted bond before maturity, results in taxable income to the extent of the discount. Then came *Helvering* v. *American Dental Co.,* 318 U. S. 322. It held that the voluntary cancellation by a creditor of part of back rent and interest on notes for merchandise claims, was not the realization of income to the debtor but a tax-free gift. Finally, came *Commissioner* v. *Jacobson,* 336 U. S. 28. It was also a bond case, and held that the *Kirby Lumber Company* principle holds good even though the bond is not bought in the open market, but was acquired by direct negotiation with the holders.

In the *Jacobson* case, the court explained that a bond situation is one where there is not likely to be a good climate for a gift. On the other hand, when an open account is involved, the court said a gift is more likely to arise.

All of these cases involved business debts and business dealings. The Court of Claims, on its own, without anything to go by from the pronouncements of the Supreme Court, and in fact contrary to the holding in the *American Dental Co.* case, ruled that business debts and business dealings, *per sese,* preclude the possibility of gift.

To justify this conclusion, the Court of Claims says that the *Jacobson* case limited the doctrine of the *American Dental Co.* case. Actually, what the Court of Claims is saying is that the *Jacobson* case emasculated or reversed the *American Dental Co.* case. The Supreme Court never so indicated or implied. In fact, the Supreme Court expressly excluded from the automatic area of the *Jacobson* case cancellation of open-account trade debts.

At all events, as things now stand, and in the face of the Court of Claims decision, confusion is both created and augmented on the whole important subject of the tax treatment of debt cancellation. The problem cries for reconciliation and finality of expression from the Supreme Court. The need and opportunity to do so are afforded by this petition.

(2) The lower courts are now in conflict.

The Court of Claims decision holds that the *Jacobson* case limited the doctrine of the *American Dental Co.* case. In *Boos* v. *Reynolds,* 84 F. Supp. 185 (D. C. Minn.), the court held just the opposite, as follows:

> "Finally, nothing said by the Supreme Court in *Commissioner* v. *Jacobson* (Jan. 17, 1949), 336 U. S. 28 (69 S. Ct. 358), wherein the question of gifts was again before the court, may be taken

to indicate disapproval of the decision in the *American Dental Co.* case."

The *Boos* case, which was affirmed by the U. S. Court of Appeals for the Eighth Circuit on March 16, 1951, —— F. (2d) ——, is ignored entirely in the Court of Claims decision. The *Boos* case has a factual setting somewhat akin to the present case, but comes off with the opposite conclusion. *There, too, business debts were involved.* A landlord cancelled back rent as part of a lease extension program. The court held that the cancellation was gratuitous in that it "gave the donor nothing which he did not otherwise have." That is exactly what is involved in the present case, except that the Court of Claims held it taxable income. It requires the voice of the Supreme Court to dissolve the conflict.

(3) The decision of the Court of Claims is opposed to reason and justice.

The idea that there can be no gifts in business flies in the face of reason, no less the decisions already cited. Though no business debts were involved, the cancellation was a gratuitous act. There was no market place, no catch-as-catch-can negotiation. Petitioner was a suppliant soliciting financial aid. In response, the creditors voluntarily cancelled part or all of the claims.

The Court of Claims confused the motive for an act with the act itself. Some creditors were influenced by the prospect of continued business with a reinvigorated company. That explains why they were willing to make a gift, but does not change the fact

of gift. The creditors were at no time compelled to act. What they did, when, and how much they did, were of their own free determination. Petitioner gave nothing in exchange. That constitutes a gift, or else the word has no meaning.

The very fact that on the one hand, creditors who did not want to go along were paid in full, and on the other, many creditors forgave the debt in full, shows that the situation was entirely in each creditor's hands to do with as he wanted. To be sure, petitioner was interested in getting the maximum gift and the creditors undoubtedly wanted to minimize the amount, but that does not change its aspect as a gift. Frequently, a solicitor of charity suggests an amount larger than the donor has in mind and some negotiation ensues before the figure is determined, but what is finally paid is still a gift to the charity.

The fact that the creditors accounted for the amounts cancelled as bad debts, not charitable contributions, is likewise besides the point. Bookkeeping treatment does not pervert the underlying facts. In *Liberty Mirror Works*, 3 T.C. 1018, a bank gratuitously forgave the unpaid portion of the taxpayer's debt. The bank treated that portion as worthless. The Tax Court said (p. 1023):

> "The bank may have considered all of the debts worthless to the extent of the amounts forgiven. In any event, we think that, under the rule of the Supreme Court in the *American Dental Co.* case, the canceled portion of the indebtedness was not taxable income to the petitioner."

Petitioner does not contend that all cancellations of business debts are nontaxable gifts. On the other

hand, not all cancellations of business debts preclude the existence of gifts. That is where the Court of Claims fell in error and needs the corrective guidance of the Supreme Court.

(4) The principle at issue is of general concern to both government and taxpayer in the administration of the tax laws, and needs the determination of this court to eliminate further litigation.

Debt cancellations arise frequently in every day business life. It is important in the administration of tax laws that their treatment be defined. The significance of the subject is shown by the fact that three times it has been welcomed beyond the threshold of this court. It now knocks again because doubts have been engendered that, unless put at rest, will create a high degree of uncertainty for government and taxpayer alike, and result in a multitude of litigation.

Wherefore, petitioner prays that this petition for a writ of certiorari be granted.

April, 1951.

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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 682

THE MARSHALL DRUG COMPANY, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (R. 14-17) is reported at 95 F. Supp. 820.

JURISDICTION

The judgment of the Court of Claims was entered March 6, 1951. (R. 18.) The petition for a writ of certiorari was filed April 19, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1255(1).

QUESTION PRESENTED

Whether business debts cancelled by petitioner's creditors for business reasons constituted taxable income to petitioner, as the Court of Claims held, or were gifts to petitioner, as it contends.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(3) [As amended by Section 111(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Gifts, bequests, devises, and inheritances.*—The value of property acquired by gift, bequest, devise, or inheritance. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

> SEC. 19.22(a)-14. *Cancellation of indebtedness.*—(*a*) *In general.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. * * * A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. * * *
>
> * * * * * *

Section 29.22(a)-13 of Treasury Regulations 111 is identical with Section 19.22(a)-14 of Treasury Regulations 103.

STATEMENT

Petitioner is a corporation, which conducts a chain of retail drug stores in the Cleveland, Ohio, area. Petitioner operated at a loss for five years prior to the year 1940, with the exception of one year. The losses resulted from the lack of proper management. On October 14, 1940, petitioner owed 947 business creditors the aggregate amount of $521,860 on past due accounts for merchandise and debts incurred in prior years. Petitioner's officers recognized that if the company was to continue to operate, a reorganization would be necessary. A plan of reorganization was evolved which included the freezing of all past due accounts as of October 14, 1940, and the bringing in of new management. The plan further contemplated an effort to persuade the trade creditors to convert their claims

into five per cent preferred stock, par value $100 on a dollar-for-dollar basis. It was proposed to have the creditors subscribe to additional stock, if possible, to obtain further working capital. (R. 8.)

A prospectus was filed with the Securities and Exchange Commission and sent to all creditors with a preferred stock subscription agreement. The prospectus stated that the new management would assume control when a minimum of $500,000 par value of preferred stock was subscribed. (R. 8-9.) Of the $521,860 of trade creditors' claims, $438,172.41 were converted into preferred stock. Many creditors agreed to subscribe to additional stock for cash. Some creditors advised petitioner that it was against their policy to take preferred stock, but that they would be glad to cooperate in any other way possible. On December 6, 1940, a letter was sent to all trade creditors who had not converted their claims into preferred stock. (R. 9.) This letter referred to the prospectus, the plan for bringing in new management, the preferred stock subscription by many of the creditors, and added (R. 9):

> In their desire to accelerate the plan some of the creditors who are unable to subscribe for Preferred Stock have indicated a willingness to discount the amount of their claim by agreeing to accept a cash payment to the extent of fifty percent thereof when the plan is declared operative.

> After serving the people of the City of Cleveland and Greater Cleveland for more than fifty years it is not a pleasant task for us to admit this financial position. With your modest assistance and with the new management we feel confident that our position of former years will be restored.
>
> It is our earnest hope, therefore, that you will find it possible to afford us some relief along the lines indicated above.

After December 6, 1940, and before February 3, 1941, the effective date of the reorganization plan, a letter was sent to the creditors who had not indicated a willingness to relinquish portions of their debt (R. 9-10). This letter read in part as follows (R. 10):

> We just cannot believe that the omission of your name from this long list of friends that participated in the program of relief is intentional on your part. As you know, our creditors assisted us through various mediums. Many not only converted their claims into the new 5% preferred stock but subscribed for an additional amount of these securities for payment in cash at par. The cash proceeds resulting from these subscriptions will be utilized by our company to physically rehabilitate our 42 units and to enable us to discount promptly invoices covering current shipments of merchandise. Where, for legal or other reasons, the creditor was unable to accept preferred stock, in his desire to afford us relief settlements were effected.

> In all fairness, therefore, to the present participants in this plan who have made our continued existence possible, and to assist us in promptly consummating our objective, we shall indeed be grateful to you if you will find it possible to adopt either of the formulas presented above and in light of the facts presented we trust you will sympathetically recognize our position. * * *

In addition to these letters, contacts were made by representatives of the petitioner with the creditors in person and by telephone, in which the financial condition of the company was explained as well as the plan to obtain new aggressive management if petitioner got the relief requested from the creditors. As a result of these overtures, business creditors with claims amounting to $72,848.80 accepted $46,697.11 in full payment thereof, which resulted in an aggregate cancellation of $26,151.69. (R. 10-11.) Trade creditors with claims amounting to $10,838.79 refused to subscribe to preferred stock or accept a reduction in their accounts and they were paid off in full. (R. 12.)

The Court of Claims expressly found that the creditors thought that full collection could not be made; that they had no intention of making a gift to petitioner; and that to some extent they were motivated by the prospect of continued business. The difference between the amount of the indebtedness and the amount received in settlement was

treated by each creditor as a bad debt on its books of account. (R. 12-13.)

On these facts, the Court of Claims held that these transactions were "business dealings"; that "[e]ach cancellation was the result of a creditor's individual business judgment" and "was not a gift." Accordingly, it dismissed petitioner's suit for refund (R. 17).

ARGUMENT

Section 22(a) of the Internal Revenue Code, *supra,* defines gross income comprehensively as including gains derived from any source whatever. The applicable Regulations, Section 19.22(a)-14 of Treasury Regulations 103, *supra,* provide that "A taxpayer realizes income by the payment * * * of his obligations at less than their face value." Section 22(b)(3) of the Internal Revenue Code, *supra,* excludes from gross income "property acquired by gift."

It is established that a reduction in or discharge of indebtedness in an arm's length business transaction results in taxable gain to the debtor, not a gift. *Commissioner* v. *Jacobson,* 336 U.S. 28; *United States* v. *Kirby Lumber Co.,* 284 U.S. 1; *Helvering* v. *Amer. Chicle Co.,* 291 U.S. 426; *cf. Helvering* v. *Amer. Dental Co.,* 318 U.S. 322.

In *Commissioner* v. *Jacobson, supra,* the debtor acquired his own bond obligations for less than their face amount and contended that the amount of debt cancellation constituted a gift which was

exempt from tax. In rejecting such contention, this Court said (pp. 38, 40-41):

> The respondent realized an immediate financial gain from his purchase of these bonds at a discount. * * * That such a gain comes within the meaning of gross income as used in federal income tax laws was long ago recognized by the Treasury Department's Regulations and by this Court in the leading cases in this field. * * *
>
> If § 22(a) stood alone, without the exclusions stated in § 22(b), the gain realized by the respondent in this case unquestionably would constitute gross income for income tax purposes. The provisions of § 22(b) and the decisions of this Court do not change that result. On the contrary, they confirm it.

Here, as in the *Jacobson* case, the taxpayer relies upon the *Amer. Dental* case. But the answer given in Mr. Justice Burton's opinion for the Court in the *Jacobson* case is equally applicable here: "The situation in each transaction is a factual one. It turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance 'for nothing'." *Commissioner* v. *Jacobson, supra,* p. 51. The facts found by the Court of Claims in this case (R. 12-13) clearly establish that the transactions here were of a business nature, and that the element of donative intent characteristic of a gift is conspicuously lacking.

Petitioner contends that the decision below conflicts with *Boos* v. *Reynolds,* 84 F. Supp. 185 (D. Minn.), affirmed by the Court of Appeals for the Eighth Circuit on March 16, 1951 (1951 P-H, par. 72,304). But the opinion of the Court of Appeals in that case shows that the issue was considered a factual one, the court stating that upon the evidence adduced it could not be declared that the trial court's finding that the cancellations in intention and fact constituted gifts was clearly erroneous. The Court of Claims in the present case took the same view that the problem turned upon the intention of the parties, the court expressly finding as a fact that "there was no intention [by the creditors] to make a gift." (R. 12.) The difference in result arose from the different views taken of the facts, and not from any difference as to the applicable legal principles.[1]

Petitioner urges, as a further ground for certiorari, that this Court's decisions in the *Jacobson, Amer. Dental,* and *Kirby Lumber* cases, taken together, have created "a sea of doubt" as to the tax treatment of debt cancellation, and that the "problem cries for reconciliation and finality of expression from the Supreme Court." But the

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[1] Unlike the pattern of solicitation and negotiation in this case, the parties in the *Boos* case, the Court of Appeals found, "had regarded and treated the back-rent accumulation [forgiven by the creditor] as being a dead issue between them." When the question arose as to how the matter of back-rent should be treated on the parties' books, the creditor replied: "Well, you don't owe me any back rent," "That is water over the dam," and "That is all to be forgotten."

Government does not believe that further review of this question is needed at this time, since we think it is now clearly settled, as the Court of Claims held in this case, that in a normal business transaction such as this, where business debts are cancelled by creditors for business reasons, no gift is involved.

CONCLUSION

The decision below is correct. There is no square conflict of decisions. The petition for certiorari should be denied.

Respectfully submitted,

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MAY 1951.

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